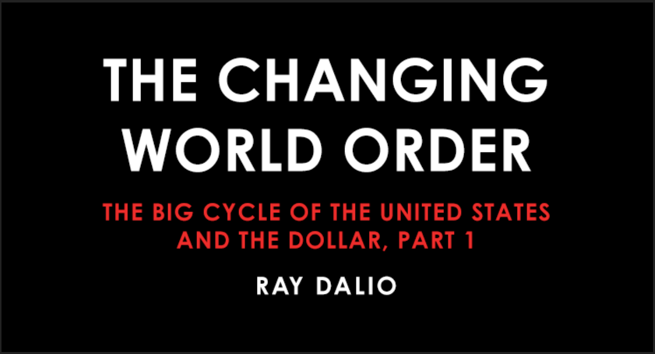
THE CHANGING WORLD ORDER
THE BIG CYCLE OF THE UNITED STATES AND THE DOLLAR, PART 1
RAY DALIO

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Chapter 4: The Big Cycle of the United States and the Dollar, Part 1

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This is Part 1 of a two-part chapter on the US Empire and its path along the archetypical big cycle of dominant powers. It covers the period up through World War II. In Part 2, we will cover from the beginning of the new world order right up to this moment. It will be out on Tuesday, July 21.

To remind you, I did this study so that I could understand how we got to where we are and how to deal with the situations we are facing, but I am no great historian. I'm just a guy with a compulsion to understand how these things work and to bet on what will happen, who has access to great research assistants, fabulous data, incredibly informed experts, lots of insightful written research, and my own experiences. I'm using all of this to try to figure out what's true and what to do about it. I am not ideological. I am mechanical. I look at reality as a perpetual-motion machine with cause/effect relationships driving developments through time. I am sharing this information with you to take or leave as you like and to have you point out any inaccuracies you think might exist as we try to figure out together what's true and what to do about it.

This chapter is a continuation of the last chapter in which we started to look at each of the leading reserve currency empires over the last 500 years, starting with the Dutch and British empires. We first saw the Dutch and then the British rise to become the richest and most powerful reserve currency empire and then decline into relative insignificance in cycles that were driven by timeless and universal cause/effect relationships. We ended with the British Empire declining in the first half of the 20th century. That brought us up to World War II, after which the British Empire was replaced by the US Empire. In this chapter we will examine the US and in the next we will examine China–now the two leading world powers–to see how they are progressing along the path of the archetypical cycle. That will complete our examination of the rises and declines of the leading empires over the last 500 years. We will then make one more quick review of the past before trying to squint into the future.

As we move closer to the present, I will increasingly shift from describing each country's story individually to weaving the most relevant countries' stories together chronologically so you can better see the interactions, and I will do it in greater detail. I will start in 1930 and bring the story up to the present for both the US and China, and then I will focus

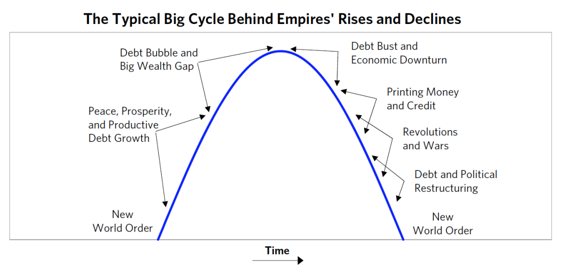
more closely on US-China interactions, which are the most important ones today. While telling the story this way will make it a bit more complicated, it will help you see how what is happening now is similar to what happened in the past because the most important forces and cause/effect relationships behind them are essentially the same. As we delve into the particulars of the last 90 years, it is easy to lose sight of the big arcs, most importantly the three big cycles–i.e., the long-term debt/monetary cycle, the wealth and political gap cycle, and the global geopolitical cycle–as well as the eight major types of power and the 17 major drivers behind them. **I will try to keep it simple, emphasizing just the most important developments in just the most influential countries, but if you find that the story starts getting more complicated than you'd like, remember that you can just read the text in bold in order to get the main points without complication.**

World affairs and history are complicated because there is a lot going on both within and between relevant countries. Understanding just the most important relevant issues of just the most important countries is challenging because one has to see all of these perspectives accurately and simultaneously. All countries are living out their own stories that transpire on a daily basis, and these stories are woven together to make up the world story. But typically, at any one time, there are only a few leading countries and a limited number of major themes that make up the major story of the changing world order. Since the end of World War I, the most relevant stories have been those of Great Britain, the United States, Germany, Japan, the Soviet Union, and China. I'm not saying that these are the only countries that matter because that isn't true. But I am saying that the story of the changing world order since World War I can be pretty well told by understanding the main developments within and between these countries. In

this chapter I will attempt to briefly tell the stories of these countries and their most important interactions. This is the highlights version of the more complete version of the stories that I will pass to you in Part 2 of this book.

In telling these stories I will try to convey them without bias. I believe that to accurately understand both history and what is happening now, I need to see things through the relevant parties' eyes, including those of enemies. ***While there are of course allies and enemies and it is tempting to demonize the enemies, most people and countries are simply pursuing their own interests in the ways they believe are best for them, so I find it productive to try to see things through their eyes and counterproductive to demonize them.*** If you hear me say things that sound sympathetic to former or existing enemies—like "Hitler built a strong economy before going to war"—please know that it is because I am seeking accuracy and need to be truthful rather than politically correct in conveying my thinking. While I might be wrong and we might not agree, that's all OK with me as long as I am describing the picture as accurately as I can.

Before I begin recounting the story of the United States I'd like to remind you of the archetypical Big Cycle that I described earlier so you can keep it in mind as you read about how events transpired up to the present. Though a super-oversimplification of the whole thing, in a nutshell it appears to me that the archetypical Big Cycle transpires as follows.


The Typical Big Cycle Behind Empires' Rises and Declines
Debt Bubble and Big Wealth Gap
Debt Bust and Economic Downturn
Printing Money and Credit
Peace, Prosperity, and Productive Debt Growth
Revolutions and Wars
Debt and Political Restructuring
New World Order
New World Order
Time

A new world order typically begins after radical changes in how things work within countries (i.e., via some form of revolution) and between countries (typically some form of war). They change in big ways who has wealth and power and the approaches used to get wealth and power. For example in 1945, when the latest world order began, the US and its capitalist and democratic allies squared off against the communist and autocratic approaches of the Soviet Union and its allies. As we saw from studying the Dutch and British empires, capitalism was key to these countries' successes but also contributed to their failures. It was successful because the pursuit of profit motivated people, and the competitive process of allocating capital and profit making directed resources relatively efficiently to what people wanted enough to pay for. In this system those who allocated efficiently profited, which led to them gaining more resources, while those who couldn't allocate well died economically.

At the same time, this system of increasing wealth produced widening wealth and opportunity gaps, as well as decadence in the form of people working less and increasingly living on borrowed money. As the wealth and opportunity gaps grew, that produced increasingly widespread views that the system wasn't fair. When the debt problems and other factors led to bad economic times at the same time as the wealth and values gaps were large,

that produced a lot of internal conflict that led to large, revolutionary changes in who had wealth and power and the processes for getting them. Sometimes these big changes were made peacefully, and sometimes they were made violently. When the leading countries suffered from these internal challenges at the same time as rival countries had become strong enough to challenge them, the risks of external wars increased. When these seismic shifts in how wealth and power are distributed occur within countries (i.e., via revolutions) or between countries (typically through wars, though sometimes peacefully), the old world order breaks down and a new world order begins, and the process starts all over again.

To refresh your memory, the chart below shows the relative powers of the leading countries as measured in indices that measure eight different types of power–education, competitiveness, innovation/technology, trade, economic output, military, financial center status, and reserve currency status. In examining each country's rise and decline I look at each of the eight measures and convey the highlights of their stories while diving into key moments to understand how they transpired in a more granular way. We will now do that with the United States and China, which as you can see in this chart are currently the leading powers.

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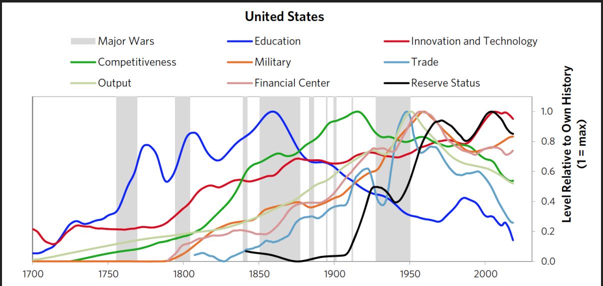
The US Empire and the US Dollar

While this section primarily focuses on the story of the US since it overtook the British Empire as the dominant global power during the world wars, we will first take a quick look at the whole arc of its rise and its somewhat recent relative decline. The chart below shows the eight types of power that make up our overall measure of power. **In it you can see the** story behind the US's rise and decline since 1700. We start in 1700 because that was just before the emergence of the United States. While the area now occupied by the United States was of course inhabited by native people for thousands of years, the history of the United States as a nation begins with the colonists, who revolted against the colonial power of Great Britain to gain independence in 1776. In the chart you can see the seeds of the US's rise going back to the early 1800s, starting with rising strengths in education and then in innovation/technology and competitiveness. These powers and world circumstances allowed the US to create massive productivity growth during the Second Industrial Revolution, which was from around 1870 to the beginning of World War I and then beyond it. These increased strengths were reflected in the US's increasing shares of global economic output and world trade, as well as growing its financial strength, exemplified in New York becoming the world's leading financial center, continuing leadership in innovations, and great usage of its financial products. You can see that these measures of the United States' powers relative to its own history reached their peaks in the 1950s immediately after the Allies won World War II. At that time, the gap between the US and the rest of the world was at its greatest and the US dollar and the US world order became dominant. Though the United States was clearly the dominant power in the post-World War II period, the Soviet Empire was a rival, though it was never nearly as strong overall. The Soviets and their communist satellite states vied against the much stronger US and US allies and satellite states until Soviet power began to fade under the weight of its growing inefficiency around 1980 and then collapsed in 1989-91. That is about when China began to rise to become a comparable rival power to the US where it is today.



As you can see, while the United States' relative strengths of education, competitiveness, trade, and production have declined significantly and steadily over the last 100 years (to now be around the 50-60th percentile versus other leading powers), its relative strength in innovation and technology, reserve currency status, financial center power, and military have remained at or near the top. At the same time, as we will see when we delve into China's picture, China has gained on the US in all these areas, has become comparable in many ways, and is advancing considerably faster than the US.

Let's now drop down from the 40,000-foot level to the 20,000-foot level and pick up our story in 1930 so we can see how the United States evolved to become the dominant world power. While we focus predominantly on the US story, the linkages between economic conditions and political conditions within the United States and between the United States and other countries—most importantly with the UK, Germany, and Japan in the 1930s, with the Soviet Union and Japan from around 1950 until 1990, and with China from around 1980 until now—must be understood because economics and geopolitics within and between countries were and always are intertwined.

1930 to 1939/41: The Economic War

As a principle:

Before there is a shooting war there is usually an economic war.

And:

Severe economic downturns with large wealth gaps, large debts, and ineffective monetary policies make a combustible combination that typically leads to significant conflicts and revolutionary changes within countries.

And:

During periods of great conflict there is a strong tendency to move to more autocratic leadership to bring order to the chaos.

In 1929 the Roaring ’20s bubble burst and the global depression followed. It led to virtually all countries having significant internal conflicts over wealth that led them to turn to more populist, autocratic, nationalistic, and militaristic leaders and policies. These moves were either to the right or to the left and occurred in varying degrees. The extremities of these degrees varied by country, according to their circumstances and the lengths and depths of their democratic or autocratic traditions. In Germany, Japan, Italy, and Spain, their extremely bad circumstances and their less well-established democratic traditions led to extreme internal conflicts and a turn to populist-autocratic leaders of the right (i.e., fascists), just as at different points in time the leaders of the Soviet Union and China, which also endured extreme circumstances and had no experience with democracy, became populist, autocratic leaders of the left (i.e., communists). The US and the UK had less severe conditions and much stronger democratic traditions, so they became more populist and autocratic than they were, but not nearly as extreme as other nations.

In addition to these economically motivated conflicts within countries and the political shifts that arose from them, all of these countries faced increased external economic conflicts as they fought for greater shares of a shrinking economic pie. Because power rather than law rules international relations, there was a sequence of intensifying tests of power that led to war and then to peace and the new world order in 1945.

To help to convey the picture in the 1930s, I will quickly run though some geopolitical highlights of what happened from 1930 until the official start of the war in Europe in 1939 and the bombing of Pearl Harbor in 1941. Then I will quickly move through the war and come to 1945 when the new world order began. I will then look at where this world order has brought us up until now. While these stories are interesting in and of themselves, they are most important to understand because of the lessons they provide for thinking about what is now happening and what’s ahead.

Because the United States and China are now in an economic war that could conceivably evolve into a shooting war, and I’ve never experienced an economic war, I studied a number of past ones to learn what they are like. That taught me a bit about economic warfare, helped me better understand what is happening now, and made me aware of possibilities that I hadn’t previously considered. Comparisons between the 1930s leading to World War II and today, especially with regard to economic sanctions, are especially interesting and helpful in considering what might be ahead. For that reason, I delve into the story of this period in a bit more detail than you might care to read. If you find that to be the case, just read the bold for the highlights.

The economic wars started about 10 years before the hot wars. The Great Depression brought economic suffering to virtually all nations, which led to fighting over wealth within and between countries that led to the hot wars that began a decade later.

In 1929 gold (and to a lesser extent silver) was money, and paper money represented a promise to deliver it (there was a Type 2 monetary system in the world, as explained in Chapter 2). In the Roaring ’20s a lot of debt (promises to deliver paper money that was convertible to gold) was created to buy speculative assets (particularly stocks). **When the Federal Reserve tightened monetary policy in 1929 to curtail the speculation, the bubble burst and the global Great Depression began.**

The debt problems in the US were ruinous for American banks, which curtailed their lending around the world, hurting international borrowers. At the same time the depression created weak demand, which led to the collapse in US imports and other countries’ sales to the US. As their incomes weakened their demand fell and more credit problems occurred in a self-reinforcing downward economic spiral. At the same time the US turned protectionist to safeguard jobs, so it raised tariffs (via the passage of the Smoot-Hawley Tariff Act) in 1930, which further depressed economic conditions in other countries.

Turning protectionist and raising tariffs to protect domestic businesses and jobs during periods of economic bad times is common. It leads to reduced efficiency because production does not occur where it can be done most efficiently, and it typically

contributes to greater global economic weakness as raising tariffs usually leads to tariff wars that typically cause the country that raised tariffs to lose exports too. It does however benefit those entities protected by the tariffs and can create political support for the leader who is imposing the tariffs.

When the Great Depression began, Germany, Japan, the Soviet Union, and China were already suffering. Germany struggled under the burdens of its World War I debt and the occupation of the Rhineland by foreign forces. Japan suffered a classic big debt crisis in 1927 that was followed by a severe depression in 1930-31 and then a classic massive currency devaluation, fiscal stimulation, and debt monetization that pretty much wiped out financial wealth in Japan. The Soviet Union suffered from its 1917-22 revolution and the civil war, a lost war to Germany, a costly war with Poland, a famine in 1921, and political purges and economic hardships through the 1930s. China suffered from civil war, poverty, and a famine in 1928-30. So when things worsened in 1930, bad conditions became desperate conditions in these countries, which set in motion the economic and eventually military conflicts that followed.

To make matters worse droughts in the US and in the Soviet Union soon followed. The drought/famine in the Soviet Union, in combination with extreme government policies, was so severe that it caused millions of deaths. ***Harmful acts of nature (e.g., droughts, floods, and plagues) have often caused periods of great economic hardship that when combined with other adverse conditions have led to periods of great conflict.*** Over the next several years in Russia internal political fighting and fears of Nazi Germany led to purges of hundreds of thousands of people who were accused of spying and shot without trials.

While Germany had previously been saddled with tremendous reparation debts following World War I, in 1929 it was beginning to emerge from under the yoke of these via the Young Plan, which provided for considerable debt relief and the departure of foreign troops from Germany by 1930. However, the global depression hit Germany hard, leading to 25% unemployment, massive bankruptcies, and extensive poverty. As is typical, a battle between populists of the left (communists) and populists of the right (fascists) emerged. Adolf Hitler, the leading populist-fascist, tapped into the mood of national humiliation to build a nationalist furor, casting as the enemy the World-War-I-ending Treaty of Versailles and the countries that imposed it. He created a nationalist program of 25 points that gave something to everyone and rallied support around it. In response to internal fighting and a desire to restore order, Hitler was appointed chancellor in January 1933, drawing large support for his Nazi Party from industrialists who feared the communists. Two months later, the Nazi Party won the most support and the most seats.

In the United States in 1932 there was the presidential election that led to the election of Franklin D. Roosevelt, who many considered a populist of the left. Promptly after his inauguration, in March/April 1933, he defaulted on the promise to convert paper dollars into gold, provided money to all banks so depositors at those banks could get their money, ordered all gold in denominations of more than $100 to be turned in for paper money at a rate of $20.67 per ounce, and devalued the dollar in relation to other currencies. There were also big fiscal spending programs that led to large budget deficits and large debts that the Federal Reserve bought with money that it printed.

As a principle: ***Deflationary depressions are debt crises caused by there not being enough money in the hands***

of debtors to service their debts. They inevitably lead to the printing of money, debt restructurings, and government spending programs that increase the supply of, and reduce the value of, money and credit. The only question is how long it takes for government officials to make this move.

In the case of the Great Depression, it took from the October 1929 peak to Roosevelt's March 1933 action to make the move. From that point until the end of 1936–the year the Federal Reserve tightened monetary policy and caused the recession of 1937-38–the stock market returned over 200%, and the economy grew at an average real rate of about 9%!

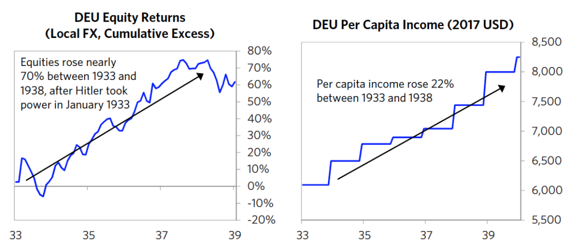
As a principle: ***During periods of severe economic distress and large wealth gaps, there are typically revolutionarily large redistributions of wealth. When done peacefully these are achieved through large tax increases on the rich and big increases in the supply of money that devalue debtors' claims, and when done violently they are achieved by forced asset confiscations.***

In Roosevelt's first 100 days in office he created a number of big government spending programs that were paid for by big tax increases and big budget deficits financed by debt that the Federal Reserve monetized. He provided jobs programs, unemployment insurance, Social Security supports, and labor- and union-friendly programs. After his 1935 tax bill, then popularly called the "Soak the Rich Tax," the top marginal income tax rate for individuals rose to 75% (versus as low as 25% in 1930). By 1941, the top personal tax rate was 81%, and the top corporate tax rate was 31%, having started at 12% in 1930. He also imposed a number of other taxes. Despite all of these taxes and the pickup in the economy that helped to raise tax revenue, budget deficits increased from around 1% of GDP to about 4% of GDP because the spending increases were so large. Specific developments through the Great Depression are explained more completely in Chapter 2: “The Big Cycle of Money, Credit, Debt, and Economic Activity” or in great detail in Part 2 of my book *Principles for Navigating Big Debt Crises*.

Meanwhile in Germany, Hitler continued to pursue nationalist policies, refusing to pay reparation debts to creditor countries. He also stepped out of the League of Nations and took autocratic control of the country in 1934. By holding the roles of both chancellor and president, he became Germany’s supreme leader. ***In democracies there are always some laws that allow countries’ leaders to grab special powers.*** Hitler seized them all. He invoked “Article 48” to put an end to many civil rights and suppress political opposition from the communists and forced the passage of the “Enabling Act,” which allowed him to pass laws without the approval of the parliament and the president. He pursued the autocratic advancement of the “Aryan race” and was ruthless against any opposition–e.g., he took control of or censored newspapers and broadcasting companies, created a secret police force (the Gestapo) to find and fight all opposition, deprived Jews of all rights of citizenship, and took control of the Protestant Church’s finances and arrested church officials who opposed him. Declaring the Aryan race superior, he prohibited non-Aryans from serving in government.

Hitler also took that same autocratic/fascist approach to building the economy, coupled with big fiscal and monetary stimulation programs. To create a strong economy for Aryan Germans, Hitler quickly privatized state-owned businesses and encouraged corporate investment that was paid for by borrowing. He acted strongly in support of raising their living standards. For example, he set up Volkswagen to make cars affordable and accessible to most people, and he directed the building of the Autobahn. He financed this substantially increased government spending by forcing banks to buy government bonds. The debts that were produced were paid back by the earnings of companies and the central bank (the Reichsbank) monetizing debt. These policies by and large worked well. This is another good example of how ***borrowing in one's own currency and increasing one's own debt and deficits can be highly productive if the money borrowed is put into investments that raise productivity that produces more than enough cash flow to service the debt and, even if it doesn't cover 100% of the debt service, it can be very cost-effective in achieving the economic goals of the country.***

As for the economic effects of these policies, when Hitler came to power in 1933 the unemployment rate was 25%. By 1938 it was nil. Per capita income between his coming to power and five years later in 1938 increased by 22% and real growth averaged over 8% per year between 1934 and 1938. Consistent with the rise in the growth, as shown in the below charts, German equities rallied nearly 70% in a steady trend between 1933 and 1938 until the onset of the hot war.



DEU Equity Returns (Local FX, Cumulative Excess)

Equities rose nearly 70% between 1933 and 1938, after Hitler took power in January 1933

DEU Per Capita Income (2017 USD)

Per capita income rose 22% between 1933 and 1938

Also in 1935 he began to build the military, making military service required and increasing Germany's military spending much faster than any other country because the German economy needed more resources to fuel itself and needed to get these from other countries so it built and used its military power to help get them. One could argue that getting them militarily was more cost-effective than trying to produce goods to trade with others to earn income to buy what was needed.

Like Germany, Japan was also hit exceptionally hard by the depression and became more autocratic in response to it. Japan was especially vulnerable to the depression because, as an island nation without adequate natural resources, it relied on exports for income to import necessities. When its exports fell by around 50% between 1929 and 1931, it was economically devastated. In 1931, the depression in Japan was so severe that the country went broke—i.e., it was forced to draw down its gold reserves, abandon the gold standard, and float its currency, which depreciated it so greatly that Japan ran out of buying power. These terrible conditions and large wealth gaps led to fighting between the left and the right. In 1932 that led to a massive upsurge in right-wing nationalism and militarism to forcefully restore order and bring back economic stability. To that end, Japan's military took control and pursued military options to get Japan the resources it needed by taking them away from other countries. Japan invaded Manchuria in 1931 and later expanded through China and Asia to obtain natural resources (e.g., oil, iron, coal, and rubber) and human resources (i.e., slave labor). As in the German case, it could be argued that this path of military aggression to get needed resources was the best path for the Japanese because relying on classic trading and economic practices wouldn't have gotten them what they needed.

Shifting to more autocratic, populist, and nationalist leaders and policies during times of extreme economic stress is typical, as people want strong leadership to bring order to the chaos and to deal strongly with the outside enemy. In 1934, there was severe famine in parts of Japan, causing even more political turbulence and reinforcing the right-wing, militaristic, nationalistic, and expansionistic movement.

In the years that followed, this movement in Japan, like that in Germany, became increasingly strong with its top-down fascist command economy, building a military-industrial complex with the military mobilized to protect its existing bases in East Asia and northern China and its expansion into other territories. As was also the case in Germany, during this time, while most Japanese companies remained outside government ownership, their production was controlled by the government.

What is fascism, and why was it adopted in countries like Germany and Japan? Consider the following three big choices that one has to make in order choose a country's approach to governance: a) bottom-up (democratic) or top-down (autocratic) decision-making, b) capitalist or communist (with socialist in the middle) ownership of production, and c) individualistic (which treats the well-being of the individual with paramount importance) or collectivist (which treats the well-being of the whole with paramount importance). Pick the one from each category that you believe works best for your nation's values and ambitions and you have your preferred approach. Fascism is autocratic, capitalist, and collectivist. Fascists believed that top-down autocratic leadership, in which the government directs the production of privately held companies in a way that individual gratification is subordinated to national success, is the best way to make the country and its people wealthier and more powerful. The United States and Great Britain believed that the democratic, capitalist, and individualistic mix was better, while the Soviet Union believed that the autocratic, communist, and collectivist mix was best.

In pursuing its capitalist approach, in 1936-37, the Federal Reserve tightened money and credit to fight inflation and slow an overheating economy, which caused the fragile US economy to go into recession and other major economies to weaken with it, further raising tensions within and between countries. Meanwhile in Europe, the conflict in Spain between the populists of the left (the communists) and the populists of the right (the fascists) flared up into the brutal Spanish Civil War. Franco of the right, with the support of Hitler, purged all left-wing organizations in Spain. In November 1937, Hitler held a secret meeting with his top officials to announce his plans for German expansion in Europe to gain resources and bring together the Aryan race. Hitler then put his plans for expansion into action, first annexing Austria and then seizing a part of Czechoslovakia that contained oil resources. Europe and the US watched warily, not wanting to get drawn into another war so soon after the devastation of World War I. Then on September 1, 1939, Germany invaded Poland. That is when England and France declared war on Germany, which is why that is the date that marks the beginning of World War II in Europe.

In the Pacific in 1937 Japan spread its occupation of China, brutally taking control of Shanghai and Nanking, killing an estimated 200,000 Chinese civilians and disarmed combatants in the capture of Nanking alone. While the US remained isolationist, it did provide China's Chiang Kai-shek government with fighter planes and pilots to fight the Japanese, thus putting a toe in the war, and conflicts between the US and Japan began to flare when a Japanese soldier struck the US consul in Nanking and Japanese fighter planes sank a US gunship anchored nearby.

The US remained reluctant to enter the wars in Europe and Asia. In fact, in November 1940, Roosevelt was re-elected for a third term by promising to keep the US out of the war, even though the US was already taking action to protect its interests, especially in the Pacific. Still the US began using economic supports for countries it sympathized with and economic sanctions against those it did not–e.g., earlier in 1940, US Secretary of War Henry Stimson initiated aggressive economic sanctions against Japan, culminating in the Export Control Act of 1940. In mid-1940 the US moved the US Pacific Fleet to Hawaii. In October, the US ramped up the embargo, restricting “all iron and steel to destinations other than Britain and nations of the Western Hemisphere.”[1] The plan was to cut off the resources needed by Japan in order to strangle them into submission and force a retreat from most of the areas they had taken over.

While in March 1941 the US still wanted to avoid the war, Congress passed the Lend-Lease Act, which allowed it to lend or lease war supplies to nations that it deemed to be acting in ways that were “vital to the defense of the United States,” which included Great Britain, the Soviet Union, and China. This was good for the US both geopolitically and economically because the US made a lot of money selling weapons, food, and other items to countries that the US favored in the war. These soon-to-be allied countries were having problems producing them while waging war, and they (most significantly Great Britain) ran out of money (i.e., gold) so the US decided to be more supportive and postpone payment until after the war (and in some cases avoiding payment entirely). The Lend-Lease policy, although not an outright declaration of war, ended the United States' neutrality.

As a principle, ***when countries are weak, opposing countries take advantage of their weaknesses to obtain gains.*** At the time, European Allied countries (France, Netherlands, Great Britain) had colonies in Asia and were overstretched fighting the war in Europe so they were unable to defend these colonies from Japanese takeovers. **Beginning in September 1940, to obtain more resources and take advantage of the European preoccupation with the war on their own continent, Japan invaded several colonies in Southeast Asia**, starting with French Indochina. In 1941, Japan extended its reach by seizing oil reserves in the Dutch East Indies to add the "Southern Resource Zone" to its "Greater East Asia Co-Prosperity Sphere." The Southern Resource Zone was a collection of mostly European colonies in Southeast Asia whose conquest would afford Japan access to key natural resources (most importantly oil, rubber, and rice). The Greater East Asia Co-Prosperity Sphere was a bloc of Asian countries controlled by Japan. The German and Japanese fascist governments were on a roll.

At the same time this Japanese territorial expansion was a threat the US's own Pacific ambitions and continued to heighten tensions with Japan. In July and August 1941 Roosevelt responded by ordering the freezing of all Japanese assets in the United States, closing Japan's ability to ship through the Panama Canal, and embargoing all oil and gas exports to Japan. This cut off three-fourths of its trade and 80% of its oil. Japan calculated that it would be out of oil in two years. **This put Japan in the position of having to choose between backing down and attacking the US.**

As with all wars ***the unknowns about what will happen in a war are far greater than the knowns a) because rival powers go into wars only when their powers are roughly comparable (because otherwise it would be stupidly suicidal for the obviously weaker power to go to war) and b) because there are way too many possible actions and reactions to anticipate. The only thing that is known at the outset of war is that it will probably be extremely painful and possibly ruinous. As a result, smart leaders typically only go into hot wars if there is no choice because the other side pushes them into the position of either fighting or losing by backing down.*** That is how World War II began.

On December 7 and 8, 1941, Japan launched coordinated attacks on US military forces in the Philippines and at Pearl Harbor. That marked the beginning of World War II in the Pacific which brought the US into the war in Europe too.

While Japan didn't have a widely recognized plan to win the war, it appears that those Japanese leaders who were optimistic planned to destroy the US Pacific Fleet and believed that the US would lose because it was fighting a war on two fronts (Europe and Asia) and because its individualistic/capitalist political system was inferior to Japan's and Germany's authoritarian, fascist systems and their command military-industrial complexes. They also believed that they had the greater willingness to endure pain and die for their country, which is a big driver of which side wins.

Before going on to describe the hot war known as World War II I want to reiterate the most common economic warfare techniques. They have been and still are:

1. Asset Freezes/Seizures: Preventing an enemy/rival from

using or selling foreign assets they rely on. These measures can range from asset freezes for targeted groups in a country (e.g., the current US sanctions of the Iranian Revolutionary Guard or the initial US asset freeze against Japan in World War II) to more severe measures like unilateral debt repudiation or outright seizures of a country's assets (some top US policy makers are now talking about not paying our debts to China).

2. **Blocking Capital Market Access:** Preventing a country from accessing their own or another country's capital markets (e.g., in 1887 Germany banned the purchase of Russian securities and debt to impede Russia's military buildup, the US now issuing threats of doing this to China).

3. **Embargoes/Blockades:** Blocking trade in goods and/or services either in one's own country, or in some cases with neutral third parties, for the purpose of weakening the targeted country or preventing it from getting essential items (e.g., the US oil embargo of Japan and cutting off its ability to ship through the Panama Canal) or blocking exports from the targeted country to other countries thus cutting off their income (e.g., France's blockade of the UK in the Napoleonic Wars).

If you're interested in seeing some of the specifics and variations that have taken place in these from 1600 until now, they are set out in a table in Appendix I.

1939/41 to 1945: The Hot War

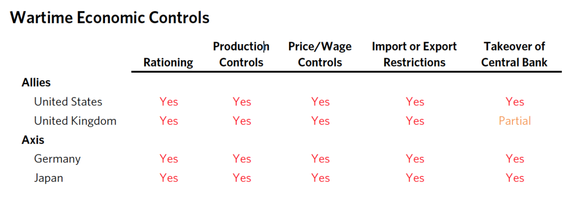
In 1940, after the war began in Europe and prior to the US entering, Germany, like Japan, looked unstoppable; it captured Denmark, Norway, the Netherlands, Belgium, Luxembourg, and France, and formed a stronger alliance with Japan and Italy, who had common enemies and were ideologically aligned. By seizing territory rapidly, Hitler's army was able to conserve oil and gain resources quickly (e.g., it gained access to oil by annexing Romania). Its roll seemed unstoppable. Its thirst for, and acquisition of, natural resources remained a major driver of the Nazi war machine pushing its campaigns into Russia and the Middle East. The war with the communist Soviet power was inevitable as Germany's conquests in Western Europe put these two big and ideologically opposed powers on a collision course. The only question was when. While the Soviet Union and Germany had signed a non-aggression pact to postpone it, the Soviet Union invaded several Eastern European states, including the Baltic states, and took control of them. Germany invaded Russia in June 1941, which put Germany in an extremely costly war for both the Western European and Russian/Soviet sides.

When the US entered the European and Pacific wars after the attack on Pearl Harbor, classic wartime economic policies were put in place in most countries by leaders who became more autocratic and whose autocratic approaches were broadly supported by their populations in opposition to the evil enemy.

Just as it is worth noting what classic economic war techniques are, it is worth noting what classic wartime economic policies within countries are. ***Classic wartime economic policies include government controls on just about everything as the country shifts resources from profit making to war making—e.g., the government determines a) what items are allowed to be produced, b) what items can be bought and sold in what amounts (rationing), c) what items can be imported and exported, d) prices, wages, and profits, e) access to one's own financial assets, and f) the ability to move one's money out of the***

country. Because wars are expensive classically g) the government issues lots of debt that is monetized, h) relies on non-credit money such as gold for international transactions because its credit is not accepted, i) governs more autocratically, j) imposes various types of economic sanctions on enemies including cutting off their access to capital, and k) experiences enemies imposing these sanctions on them.

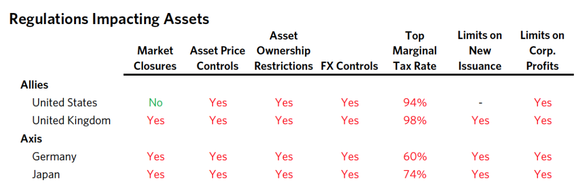
The table below shows the economic controls that were put in place during the war years in each of the major countries.



Wartime Economic Controls

	Rationing	Production Controls	Price/Wage Controls	Import or Export Restrictions	Takeover of Central Bank
Allies					
United States	Yes	Yes	Yes	Yes	Yes
United Kingdom	Yes	Yes	Yes	Yes	Partial
Axis					
Germany	Yes	Yes	Yes	Yes	Yes
Japan	Yes	Yes	Yes	Yes	Yes

The market movements during the hot war years were heavily affected by both government controls and how countries did in battles as the odds of wins and losses changed. The table below shows the controls over markets and capital flows that were put in place by country during the war years.

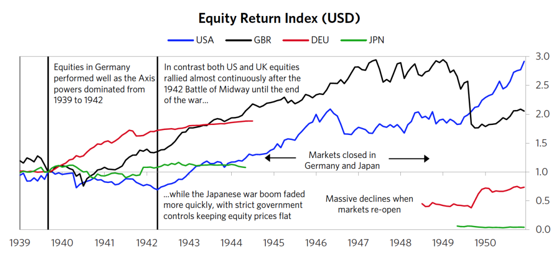


Regulations Impacting Assets

	Market Closures	Asset Price Controls	Asset Ownership Restrictions	FX Controls	Top Marginal Tax Rate	Limits on New Issuance	Limits on Corp. Profits
Allies							
United States	No	Yes	Yes	Yes	94%	-	Yes
United Kingdom	Yes	Yes	Yes	Yes	98%	Yes	Yes
Axis							
Germany	Yes	Yes	Yes	Yes	60%	Yes	Yes
Japan	Yes	Yes	Yes	Yes	74%	Yes	Yes

Stock market closings in a number of countries were common, leaving investors in stocks stuck without access to their capital. If you want to see these closures and how they transpired to understand the range of possibilities and the cause/effect relationships behind them, you can see a list of them in Appendix II.

Because losing wars typically leads to a total wipeout of wealth and power, movements of those stock markets that remained open in the war years were largely driven by how countries did in key battles as these results shifted the probability of victory or defeat for each side. For example, German equities outperformed at the beginning of WWII as Germany captured territory and established military dominance while they underperformed after Allied powers like the US and UK turned the tide of the war. After the 1942 Battle of Midway, Allied equities rallied almost continuously until the end of the war, while Axis equities were flat or down. As shown, both the German and Japanese stock markets were closed for the end of the war, didn't reopen for around five years, and were virtually wiped out, while US stocks were extremely strong.



As a principle: ***Protecting one's wealth in times of war is difficult, as normal economic activities are curtailed, traditionally safe investments are not safe, capital mobility is limited, and high taxes are imposed when people and countries are fighting for their survival. During difficult times of conflict protecting the wealth of those who have wealth is not***

a priority relative to redistributing wealth to get it to where it is needed most.

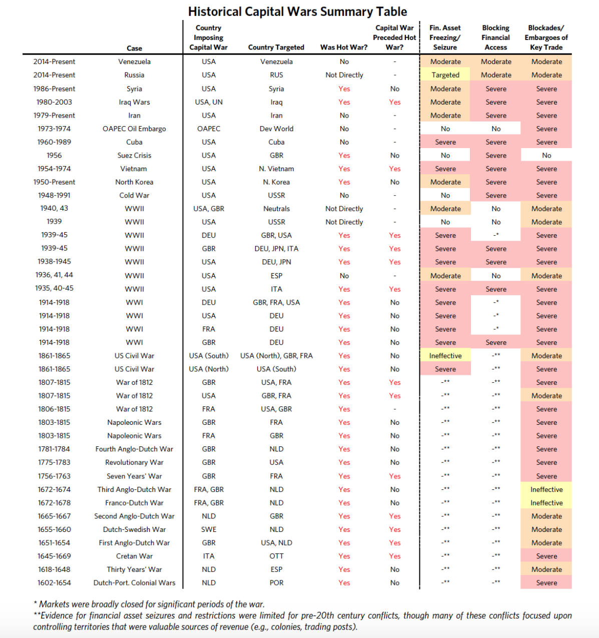
That was the case in those war years.

While we won't cover the actual battles and war moves, the headline is that **the Allied victory in 1945 produced a tremendous shift of wealth and power.**

World War II was an extremely costly war in lives and money. The numbers are gigantic and extremely imprecise. **An estimated 40-75 million people were killed as a result of it, which was 3% of the world's population, which made it the deadliest war yet.** More than half of these losses were Russian (around 25 million) and Chinese (around 20 million). Germany lost around 7 million people—just over half were military deaths and the rest were German civilian deaths, mostly from the Holocaust (and millions more non-Germans were also victims). Britain and the United States each lost around 400,000. The financial cost of the war was both enormous and inestimable, according to most experts, but, based on my research, was in the vicinity of $4-7 trillion in current dollars. What we do know is that **on a relative basis the US came out a big winner because the US sold and lent a lot before and during the war, basically all of the fighting took place off of US territory so the US wasn't physically damaged, and US deaths were comparatively low in relation to those of most other major countries.**

In Part 2 of this chapter, we will explore the new world order starting with the US as the dominant power and tell the story that brings us right up to this moment. Then we will turn to China.

Appendix I: Some Historical Cases of Capital Wars



Historical Capital Wars Summary Table

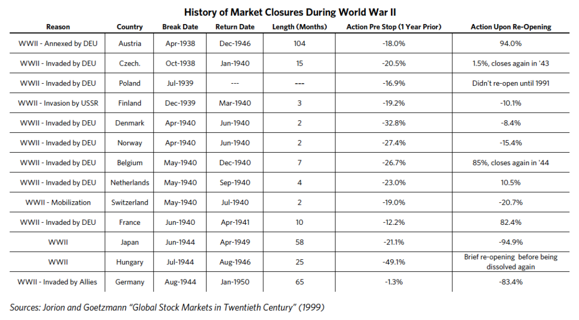
	Case	Country Imposing Capital War	Country Targeted	Was Hot War?	Capital War Preceded Hot War?	Fin. Asset Freezing/ Seizure	Blocking Financial Access	Blockades/ Embargoes of Key Trade
2014-Present	Venezuela	USA	Venezuela	No	-	Moderate	Moderate	Moderate
2014-Present	Russia	USA	RUS	Not Directly	-	Targeted	Moderate	Moderate
1986-Present	Syria	USA	Syria	Yes	No	Moderate	Severe	Severe
1980-2003	Iraq Wars	USA, UN	Iraq	Yes	Yes	Moderate	Severe	Severe
1979-Present	Iran	USA	Iran	No	-	Moderate	Severe	Severe
1973-1974	OAPEC Oil Embargo	OAPEC	Dev World	No	-	No	No	Severe
1960-1989	Cuba	USA	Cuba	No	-	Severe	Severe	Severe
1956	Suez Crisis	USA	GBR	Yes	No	No	Severe	No
1954-1974	Vietnam	USA	N. Vietnam	Yes	Yes	Severe	Severe	Severe
1950-Present	North Korea	USA	N. Korea	Yes	No	Moderate	Severe	Severe
1948-1991	Cold War	USA	USSR	No	-	No	Severe	Severe
1940, 43	WWII	USA, GBR	Neutrals	Not Directly	-	Moderate	No	Moderate
1939	WWII	USA	USSR	Not Directly	-	No	No	Moderate
1939-45	WWII	DEU	GBR, USA	Yes	Yes	Severe	-*	Severe
1939-45	WWII	GBR	DEU, JPN, ITA	Yes	Yes	Severe	Severe	Severe
1938-1945	WWII	USA	DEU, JPN	Yes	Yes	Severe	Severe	Severe
1936, 41, 44	WWII	USA	ESP	No	-	Moderate	No	Moderate
1935, 40-45	WWII	USA	ITA	Yes	Yes	Severe	Severe	Severe
1914-1918	WWI	DEU	GBR, FRA, USA	Yes	No	Severe	-*	Severe
1914-1918	WWI	USA	DEU	Yes	No	Severe	-*	Severe
1914-1918	WWI	FRA	DEU	Yes	No	Severe	-*	Severe
1914-1918	WWI	GBR	DEU	Yes	No	Severe	Severe	Severe
1861-1865	US Civil War	USA (South)	USA (North), GBR, FRA	Yes	No	Ineffective	-**	Moderate
1861-1865	US Civil War	USA (North)	USA (South)	Yes	No	Severe	-**	Severe
1807-1815	War of 1812	GBR	USA, FRA	Yes	Yes	-**	-**	Severe
1807-1815	War of 1812	USA	GBR, FRA	Yes	Yes	-**	-**	Moderate
1806-1815	War of 1812	FRA	USA, GBR	Yes	-	-**	-**	Severe
1803-1815	Napoleonic Wars	GBR	FRA	Yes	No	-**	-**	Severe
1803-1815	Napoleonic Wars	FRA	GBR	Yes	No	-**	-**	Severe
1781-1784	Fourth Anglo-Dutch War	GBR	NLD	Yes	No	-**	-**	Severe
1775-1783	Revolutionary War	GBR	USA	Yes	No	-**	-**	Severe
1756-1763	Seven Years' War	GBR	FRA	Yes	Yes	-**	-**	Severe
1672-1674	Third Anglo-Dutch War	FRA, GBR	NLD	Yes	No	-**	-**	Ineffective
1672-1678	Franco-Dutch War	FRA, GBR	NLD	Yes	No	-**	-**	Ineffective
1665-1667	Second Anglo-Dutch War	NLD	GBR	Yes	Yes	-**	-**	Moderate
1655-1660	Dutch-Swedish War	SWE	NLD	Yes	Yes	-**	-**	Moderate
1651-1654	First Anglo-Dutch War	GBR	USA, NLD	Yes	Yes	-**	-**	Moderate
1645-1669	Cretan War	ITA	OTT	Yes	Yes	-**	-**	Severe
1618-1648	Thirty Years' War	NLD	ESP	Yes	No	-**	-**	Moderate
1602-1654	Dutch-Port. Colonial Wars	NLD	POR	Yes	No	-**	-**	Severe

** Markets were broadly closed for significant periods of the war.*

***Evidence for financial asset seizures and restrictions were limited for pre-20th century conflicts, though many of these conflicts focused upon controlling territories that were valuable sources of revenue (e.g., colonies, trading posts).*

Appendix II: Cases of Market Closures in the World Wars

The table below provides a list of all the key countries that closed their markets during WWII to give you an idea of how these things go.



History of Market Closures During World War II

Reason	Country	Break Date	Return Date	Length (Months)	Action Pre Stop (1 Year Prior)	Action Upon Re-Opening
WWII - Annexed by DEU	Austria	Apr-1938	Dec-1946	104	-18.0%	94.0%
WWII - Invaded by DEU	Czech.	Oct-1938	Jan-1940	15	-20.5%	1.5%, closes again in '43
WWII - Invaded by DEU	Poland	Jul-1939	---	---	-16.9%	Didn't re-open until 1991
WWII - Invasion by USSR	Finland	Dec-1939	Mar-1940	3	-19.2%	-10.1%
WWII - Invaded by DEU	Denmark	Apr-1940	Jun-1940	2	-32.8%	-8.4%
WWII - Invaded by DEU	Norway	Apr-1940	Jun-1940	2	-27.4%	-15.4%
WWII - Invaded by DEU	Belgium	May-1940	Dec-1940	7	-26.7%	85%, closes again in '44
WWII - Invaded by DEU	Netherlands	May-1940	Sep-1940	4	-23.0%	10.5%
WWII - Mobilization	Switzerland	May-1940	Jul-1940	2	-19.0%	-20.7%
WWII - Invaded by DEU	France	Jun-1940	Apr-1941	10	-12.2%	82.4%
WWII	Japan	Jun-1944	Apr-1949	58	-21.1%	-94.9%
WWII	Hungary	Jul-1944	Aug-1946	25	-49.1%	Brief re-opening before being dissolved again
WWII - Invaded by Allies	Germany	Aug-1944	Jan-1950	65	-1.3%	-83.4%

Sources: Jorion and Goetzmann "Global Stock Markets in Twentieth Century" (1999)

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[1] As quoted in Harry Elmer Barnes, *Perpetual War for Perpetual Peace: A Critical Examination of the Foreign Policy of Franklin Delano Roosevelt And Its Aftermath*, 1953.

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